

**Northwestern Mutual***

Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551
E-mail: regs.comments@federalreserve.gov

September 16, 2016

Re: Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities (RIN 7100-AE 53; Docket No. R-1539)

Dear Mr. Frierson:

Founded in 1857, Northwestern Mutual is one of the largest life insurers in the United States, with over \$1.5 trillion of life insurance in force, total assets over \$238 billion, and over 4 million policy owners with over 96% persistency. As a mutual, the company is owned by the policy owners who share in any earnings and surplus that is not retained by the company for the purpose of ensuring solvency and financial strength.

The company has consistently maintained the highest available ratings for a US insurance company for financial strength and security throughout its modern history. Effective risk management is a priority, so we have a strong interest in regulatory developments that concern measurement of risk and capital strength. While Northwestern Mutual is not regulated by the Federal Reserve Board (Board), the proposed capital requirements (Building Block Approach or BBA and Consolidated Approach or CA) fall squarely in this area of interest, with the BBA having a greater interest for us and to which we will direct most of our responses. We appreciate the Board's open process and the opportunity to comment.

In our view, for any regulatory capital framework to be effective and credible it must:

- accurately reflect the financial strength of the insurance institution over time through varied economic conditions,
- address all material risks,
- be applied uniformly to institutions subject to the framework and
- be based on information that is standardized and verified.

Overall, we view the conceptual approach reflected in the Advance Notice of Proposed Rulemaking (ANPR) of building up from legal entity financial strength metrics (BBA) as an appropriate tailoring of risk measurement techniques to the regulatory objectives and circumstances of insurance groups with insured depository institutions. And, while we believe that the Board could successfully apply the BBA to meet its regulatory objectives for systemically designated institutions, we recognize that the effectiveness of supervision may benefit from applying a solvency metric to a consolidation of assets, liabilities and equity (CA) in order to help compensate for the imperfections inherent in any single method.

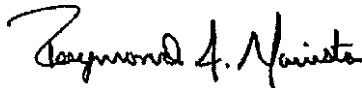
Both of these conceptual approaches have their advantages and disadvantages and will involve difficult technical and potentially controversial decisions in the exercise of the professional judgement necessary for their effective implementation. We do not believe that the Board should be deterred by these challenges.

For ease of consideration and compilation we have ordered our responses to selected questions from the ANPR in a way that reflects a constructive response while minimizing the duplication of answers. All of our responses presume a thoughtful design and thorough field test of both BBA and CA. We look forward to your consideration of our comments and the questions that you may have.

Respectfully submitted,



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General considerations

1. *Are these identified considerations appropriate? Are there other considerations the Board should incorporate in its evaluation of capital frameworks for supervised institutions significantly engaged in insurance activities?*

Yes. We believe that the considerations included in the sections entitled "I. Introduction" and "II. Consolidated Capital Frameworks for Supervised Institutions Significantly Engaged in Insurance Activities: Two Options" are appropriate. In particular, the recognition that the framework must take account of risks across the firm, that the framework should be as standardized as

possible and not place undue reliance on internal modeling or non-US standards, and that the framework strike a balance between simplicity and risk sensitivity are desirable attributes.

2. *Should the same criteria apply to all supervised insurance institutions?*

No. In accord with your statutory mandate you have distinguished in the ANPR between insurance firms which you supervise that are systemically important, and those that are not. In these cases the purpose of regulation differs, and so should the frameworks. However, applying both the CA and BBA frameworks may be useful in circumstances where verified information is available and doing so would strengthen the regulatory analysis. In particular, the BBA framework can be designed to apply to all supervised insurance institutions with a focus on entity-level financial strength measurements and an aggregated view of how close to regulatory thresholds the institution is running when compared with others thus reflecting risk exposure by entity and in total.

3. *What criteria should the Board use to determine whether a supervised insurance institution should be subject to regulatory capital rules tailored to the business of insurance?*

We believe that the existence of insurance liabilities (not dedicated assets) is a primary indicator that some or all of the institution should be made subject to regulatory capital rules tailored to the business of insurance. The BBA approach can be designed to apply rules tailored to the business of insurance to those elements of the institution in the insurance business, with other standards applied to non-insurance elements as appropriate.

4. *If multiple frameworks are used, what criteria should be used to determine whether a supervised insurance institution should be subject to each framework?*

As stated in the ANPR, "The capital standards developed by the Board take into account the overall risk profile and the size, scope, and complexity of the operations of the institution." We concur with this general approach which should inform the application of appropriate frameworks. Insurance institutions which come under Board supervision under the following circumstances:

- own a bank or thrift,
- are not designated systemically important,
- the bank or thrift represents a relatively small part of the total institution and
- the cost of requiring the creation of a new consolidated regulatory balance sheet would likely outweigh the regulatory benefit are,

in our view, the most appropriate candidates for the BBA framework. This is because the Board is supervising these institutions primarily to protect the insured depository institution (IDI) within the larger enterprise.

For those insurance institutions which come under Board supervision because they have been designated as systemically important by the Financial Stability Oversight Council (FSOC) the regulatory objective is to minimize systemic risk by making the supervised institutions more resilient to economic shocks. Our view is that, while the Board could successfully apply the BBA to meet this regulatory objective, the effective supervision of institutions like these may benefit from the application of more than one capital strength metric in order to compensate for the imperfections inherent in any single method. In this regard, if the information is available from the insurance institution, the CA and the BBA could be developed and used in a complementary way to monitor trends in risk and the sources of capital strength. Whenever the results diverge between the two approaches, or from historic norms, potentially useful inquiries can be made.

5. *In addition to insurance underwriting activities, what other activities, if any, should be used to determine whether a supervised institution is significantly engaged in insurance activities and should be subject to regulatory capital requirements tailored to the business mix and risk profile of insurance?*

Non-insurance underwriting activities integral to the business of insurance would, in our view, include:

- Reinsurance of underwritten business
- Acquisition and management of assets backing insurance liabilities
- Use of defined hedging strategies to better match insurance asset and liability cash flows

Option 1: Building Block Approach (BBA)

6. *What are the advantages and disadvantages of applying the BBA to the businesses and risks of supervised institutions significantly engaged in the business of insurance?*

Advantages of BBA

- BBA is built upon financial strength ratios for the regulated entities within a group and combines them into an aggregate group solvency ratio so that a regulator or supervisory college can compare jurisdictional metrics, assess entity and group risk exposure relative to existing regulatory thresholds, identify problematic risks and whether the entities are sufficiently capitalized.
- This entity level focus reveals increments, decrements and potential constraints on the movement of capital which would be useful should a source-of-strength remedy become an issue for the involved regulators.
- The entity level focus of BBA allows regulators to separately isolate and evaluate unregulated activities and risk concentrations that might impair the regulated entities of the group, or the group's survival in general using tools

such as the own risk and solvency assessment (ORSA), basic leverage computations and other analytical tools.

- BBA provides a level of comparability without forcing all groups onto a new basis of valuation, while still highlighting those groups which in the aggregate may be running their regulated activity closer to regulatory thresholds than others. This is cost effective and expeditious for the regulator and regulated because it makes full use of existing frameworks.
- Techniques such as cash flow stress testing or reverse stress testing are compatible with BBA as they can be used to evaluate the strength of the more significant entities in the group as a complement to the jurisdictional approach.
- BBA inherently captures idiosyncratic risks from entity level jurisdictions because local frameworks are typically designed to recognize and address those risks. Idiosyncratic risk can arise for many reasons including insured local population mortality and morbidity, effectiveness of the applicable health care system, geography and strength of infrastructure. Local frameworks tend to account for a jurisdiction's legal system, taxation regime, special product features and customer and societal expectations. This benefit is difficult to replicate in a consolidated approach where assets and liabilities from entities in different jurisdictions are combined and subjected to generalized risk charges or stress scenarios intended to estimate expected loss. Also, replicating this feature in a CA calculation is redundant with what is already available in the BBA.

Disadvantages of BBA

- BBA will require regulators to have a working knowledge of the local regimes applicable to the significant entities of the supervised institution. This will be a smaller disadvantage when dealing with less diversified business models that operate in a limited number of jurisdictions. For supervised institutions operating in many jurisdictions this matter will be more of a disadvantage. Yet, relative to the consolidated approach this is less of a disadvantage than might first appear since an effective application of a CA requires significant local knowledge in order to identify limitations that consolidation might otherwise obscure. A properly designed field test of supervised institutions should illuminate any actual problems and the solutions.
- BBA requires that attention be given to setting scalars. The application of a common methodology in setting and updating the scalars should mitigate controversy and make the process routine after the first time through.
- Care on the part of the institution and Board examiners will be necessary to eliminate intercompany transactions and avoid double counting or the omission of key risks. For the entities in the group which prepare financial statements on a US GAAP or statutory basis the related party disclosures

and underlying records will provide a basis for quantification and adjustment of the transactions as part of preparing a BBA calculation.

7. *What challenges and benefits do you foresee to the development, implementation, or application of the BBA? To what extent would the BBA utilize existing records, data requirements, and systems, and to what extent would the BBA require additional records, data, or systems? How readily could the BBA's calculations be performed across a supervised institution's subsidiaries and affiliates within and outside of the United States?*

Our response to this question overlaps with question 6 as the advantages/benefits and disadvantages/challenges tend to correspond with one another. We would add that the BBA, if it were to apply to Northwestern Mutual, would not likely require new systems. It would require the keeping of summary records specific to following BBA instructions, documenting the calculation and making the appropriate reporting to the relevant authority.

8. *What scalars and adjustments are appropriate to implement the BBA, and make the BBA effective in helping to ensure resiliency of the firm and comparability among firms, while minimizing regulatory burden and incentives and opportunity to evade the requirements?*

In our view scalar development involves identifying the regulatory threshold in each qualified jurisdiction at which point the regulator does not intervene on capital adequacy grounds and equating them. This is essentially the prescribed capital requirement (PCR) similar to that described by the International Association of Insurance Supervisors (IAIS) in Insurance Core Principle (ICP) 17 - Capital Adequacy. This provides an equivalent reference point for each regime.

A qualified jurisdiction is one in which the IAIS insurance core principles (ICPs) are assessed by the International Monetary Fund (IMF) as observant or largely observant. For those entities and jurisdictions within the institution that fail this requirement or are unassessed, the local financial strength metric should be recomputed by the institution using rules from a suitable observant or largely observant jurisdiction determined by the Board.

In addition to identifying scalars based on when regulators from different jurisdictions require similar actions, a refinement which reflects the level of conservatism in liability measurement would make the scalar more precise and reduce incentives for jurisdictional arbitrage. This would involve combining in one scalar the PCR based factor noted above with an excess capital ratio for a given jurisdiction using data from a sample of representative insurers. In order to respect insurance regulatory jurisdictional constraints on capital movement, any adjustment to reflect conservatism should not presume that margins in reserves established under more conservative regimes (such as existing US formulaic

reserves) are available as capital outside the insurance entity but, instead, should adjust for lesser degrees of conservatism in other regimes.

The number and type of scalars necessary will depend on the supervised institution, the entities it maintains and the jurisdictions in which they operate. We would expect that the initial development of scalars for the major insurance markets in the world (e.g. Japan, European Union, Canada, Australia) would take some time and research, but once established would not change materially during periodic updating except when major revisions to a jurisdictional regime occurs. These scalars would be used by the institutions to perform their BBA computations.

To further minimize regulatory arbitrage and make the BBA result more credible and consistent, variances from national standards (e.g. permitted and prescribed practices in the US) need to be reversed for purposes of the calculation. This applies to all jurisdictions included in the calculation. We address this further in our response to Question 15.

9. To what extent is the BBA prone to regulatory arbitrage?

BBA is built on jurisdictional metrics which may handle risk and qualifying capital in different ways. At a conceptual level this suggests the opportunity for regulatory arbitrage. However, arbitrage opportunities would be significantly lessened by the use of the scalars and adjustments included in our response to Question 8.

Moreover, to the extent that differences in jurisdictional metrics represent actual barriers to movement of capital from the legal entity, it is important that the group capital measure account for those barriers. Otherwise, the group measure may overstate the financial strength of the group in times of stress.

It's important to recognize that the development and use of any option like BBA or CA brings with it tradeoffs like those we outlined in our response to Question 6. The effectiveness of either option will depend on taking the fullest advantage of the benefits while employing techniques which compensate for the disadvantages.

10. Which jurisdictions or capital regimes would pose the greatest challenges to inclusion in the BBA?

In our view the greatest challenge will be presented by the jurisdictional capital regimes which are less than largely observant of the ICPs. The entities within the institution subject to those regimes will need to restate their results using a regime which is at least largely observant of the ICPs and determined by the Board. This may prove controversial. However, if the Board confines the primary use of the BBA to institutions with less diversified business models that operate in a limited number of jurisdictions this potential issue may be very manageable.

11. How should the BBA apply to a supervised institution significantly engaged in insurance where the ultimate parent is an insurer that is also regulated by a state

insurance commissioner? Are there other organizational structures that could present challenges?

When the ultimate parent is an insurer regulated by a US state insurance commissioner the standards of the National Association of Insurance Commissioners (NAIC) are applied to the entire enterprise through the application of risk based capital requirements and statutory accounting. The resulting risk based capital ratio of the parent is arguably a group solvency ratio and today is used for regulatory, rating agency and analyst purposes. Stress scenarios can be applied at this level to test the resiliency of the group.

However, it may be informative to the Board and other regulatory authorities to examine individual regulated entities within the group using their individual capital strength ratios to identify capital increments, decrements and constraints on the movement of capital. Stress scenarios could be applied at this level to test the resiliency of regulated entities within the group. This provides a more in-depth view of how the enterprise has decided to employ capital and bear risk. The advantages of BBA discussed in Question 6 expand on this benefit, in particular the evaluation of unregulated entities using ORSA, leverage computations and other analytical tools.

In circumstances where non-insurance holding companies separately own insurance and non-insurance entities the application of BBA requires more effort. But as we said in our response to Question 6; the entity level focus of BBA allows regulators to separately isolate and evaluate unregulated activities and risk concentrations that might impair the regulated entities of the group, or the group's survival in general using tools such as the own risk and solvency assessment, basic leverage computations and other analytical tools. We would add that this is well-suited for identifying financial contagion and protecting an IDI.

12. *Is the BBA an appropriate framework for insurance depository institution holding companies? How effective is the BBA at achieving the goal of ensuring the safety and soundness of an insurance depository institution holding company?*

In our view the BBA is a most appropriate and effective framework for understanding and regulating insurance depository institution holding company financial strength when the primary regulatory objective is to protect the safety and soundness of an IDI within a supervised insurance institution. Inherent in the BBA design is the requirement to identify capital strength and risk on an entity-by-entity basis within the institution. This is unique to BBA and essential for the Board to aid in the protection of the IDI while also performing an overall regulatory function for the institution.

Many of the advantages we listed in our response to Question 6 apply here.

13. *Would the BBA be appropriate for larger or more complex insurance companies that might in the future acquire a depository institution?*

Yes. Although more initial development is needed, once in use by the Board BBA is flexible enough to be applied quickly and effectively to larger or more complex insurance institutions that come under Board supervision due to their acquisition of a depository institution. This is because BBA uses existing regulatory frameworks, scalars to calibrate and equate those frameworks, and an aggregate and entity-by-entity analytical perspective.

14. In applying the BBA, what baseline capital requirement should the Board use for insurance entities, banking entities, and unregulated entities?

As we stated in our response to Question 4, the best suited application of BBA would be for those insurance institutions that come under Board supervision because they own an IDI. In that context, our past work on an aggregation approach similar in concept to BBA suggests to us that the baseline capital requirement should be US RBC for the insurance entities, with Basel III as applied in the US for the banking and unregulated entities.

However, field testing should be used to determine the significance of the banking and non-insurance entities in the population of insurance institutions supervised by the Board as well as the utility and appropriateness of this suggestion.

15. How should the BBA account for international- or state-regulator-approved variances to accounting rules?

The BBA, applied to an insurance institution with an IDI, would need to include computational steps performed by the institution to adjust for international or state-regulator approved variances to promulgated national standards as follows:

1. Quantify all types of contingent assets that are treated as admitted assets or reinsurance credits backing reserves throughout the group as a decrease to available capital.
2. Quantify all cash market assets posted as collateral to secure counterparty obligations payable upon an insured event or events, such as reinsurance collateral required by treaty, for the benefit of an insurer member of the group as an increase to available capital while not double-counting reinsurance reserve credit.
3. Quantify all variances from national reserving standards which result in higher reserves as an increase to available capital.
4. Quantify all variances from national reserving standards which result in lower reserves as a decrease to available capital.
5. Quantify all other permitted or prescribed practices at variance from national standards as an increase or decrease to available capital as appropriate.

Adjustments 1 through 5 should be reflected in the available capital of the respective entities in the group used to compute the BBA group solvency ratio.

Contingent asset is defined for this purpose as a potential economic benefit that is dependent on future events that cannot be controlled by the supervised institution or that creates an obligation of the supervised institution or any of its affiliates.

16. What are the challenges in using financial data under different accounting frameworks? What adjustments and/or eliminations should be made to ensure comparability when aggregating to an institution-wide level?

The fundamental challenges stem from the fact that under different accounting frameworks transactions and balances are defined and valued differently. The variations can be myriad and attempting to adjust one basis to another can be resource intensive and prone to error. In terms of adjustments when aggregating to an institution-wide level, the elimination of the effects of intra group transactions (including reinsurance) and the reversal of prescribed and permitted practices would top our list.

17. What approaches or strategies could the Board use to calibrate the various capital regimes without needing to make adjustments to the underlying accounting?

Please see our response to Question 8 on scalar development and adjustments.

18. How should the BBA address intercompany transactions?

Please see our response to Questions 8 and 16.

19. What criteria should be used to develop scalars for jurisdictions? What benefits or challenges are created through the use of scalars?

Please see our response to Question 8 on scalar development and adjustments. We discuss identifying scalars based on when regulators from different jurisdictions require similar actions, plus a refinement which reflects the level of conservatism in liability measurement which would make the scalar more precise and reduce incentives for jurisdictional arbitrage. This would involve combining in one scalar the PCR based factor noted above with an excess capital ratio for a given jurisdiction using data from a sample of representative insurers. In order to respect insurance regulatory jurisdictional limits on capital movement, any adjustment to reflect conservatism should not presume that margins in reserves established under more conservative regimes (such as existing US formulaic reserves) are available as capital outside the insurance entity but, instead, should adjust for lesser degrees of conservatism in other regimes.

A well-developed scalar accounts for many comparative factors between regimes such as the measurement of assets, liabilities, required and available capital.

The primary benefit of a scalar is that it is an efficient way to improve comparability and can be used whenever the comparative jurisdictions are

present in supervised insurance institutions. The challenge, while minor in comparison to the benefit, is in its initial development and periodic updating.

20. What are the costs and benefits of a single, uniform, consolidated definition of qualifying capital in the BBA?

The cost will arise from the time and resources necessary to complete the initial development and periodic updating of the definition. The benefit would theoretically be less incentive to arbitrage regulatory jurisdictions. However, this same benefit arises from well-developed scalars leaving a question as to which approach more effectively achieves the benefit. The answer would require a separate study which should consider the extent of non-US entities within the Board - supervised insurance institutions to which BBA would be applied.

21. If the Board were to adopt a version of the BBA that employs a uniform, consolidated definition of qualifying capital, what criteria should the Board consider? What elements should be treated as qualifying capital under the BBA?

We would suggest starting with the current US system of RBC and statutory accounting as a model which tends to emphasize loss absorbency and permanence as characteristics of qualifying capital.

22. Should the Board categorize qualifying capital into multiple tiers, such as the approach used in the Board's Regulation Q? If so, what factors should the Board consider in determining tiers of qualifying capital for supervised institutions significantly engaged in insurance activities under the BBA?

If the Board categorizes qualifying capital into multiple tiers we believe that the characteristics of loss absorbency, permanence and subordination are critical considerations in determining appropriate tiers.

Option 2: Consolidated Approach (CA)

In light of the early stage of development of CA, we have chosen to confine our limited opinions to the Question 23 response. The remaining unanswered ANPR questions are included for reference and completeness.

23. What are the advantages and disadvantages of applying the CA to the businesses and risks of supervised institutions significantly engaged in insurance activities?

An advantage of CA, as indicated in our response to Question 4, is that the effective supervision of complex insurance-centric groups may benefit from the application of more than one capital strength metric in order to compensate for the imperfections inherent in any single method. In this regard, if the information is available from the insurance institution, the CA and the BBA could be developed and used in a complementary way to monitor trends in risk and the sources of

capital strength. Whenever the results diverge between the two approaches, or from historic norms, potentially useful inquiries can be made.

Another advantage of CA arises if the foundational financial reporting includes the application of established consolidation rules which eliminate intra-group transactions (e.g. US GAAP).

If applied in lieu of the BBA, the CA would have the relative disadvantage of forgoing the important entity-level information inherently made available through the BBA, including potential constraints on the movement of capital.

Given the CA's earlier stage of development, it is difficult to give a full assessment. Other disadvantages or advantages may emerge as details become available.

24. What are the likely challenges and benefits to the development, implementation, and application of the CA? To what extent could the CA efficiently use existing records, data requirements, and systems, and to what extent would the CA require additional records, data, or systems?

25. To what extent would the CA be prone to regulatory arbitrage?

26. Is the CA an appropriate framework to be applied to systemically important insurance companies? What are the key challenges to applying the CA to systemically important insurance companies? How effective would the CA be at achieving the goals of ensuring the safety and soundness of a systemically important insurance company as well as minimizing the risk of a systemically important insurance company's failure or financial distress on financial stability?

27. What should the Board consider in determining more stringent capital requirements to address systemic risk? Should these requirements be reflected through qualifying capital, required capital, or both?

28. What should the Board consider in developing a definition of qualifying capital under the CA? What elements should be treated as qualifying capital under the CA?

29. For purposes of the CA, should the Board categorize qualifying capital into multiple tiers? What criteria should the Board consider in determining tiers of qualifying capital for supervised institutions engaged in insurance activities under the CA?

30. What risk segmentation should be used in the CA? What criteria should the Board consider in determining its risk segments? What criteria should the Board consider in determining how granular or risk sensitive the segmentation should be?

31. What challenges does U.S. GAAP present as a basis for segmentation in the CA?

32. *What are the pros and cons of using the risk segmentation framework in the proposed Consolidated Financial Statements for Insurance Systemically Important Financial Institutions as the basis of segmentation for the CA?*
33. *How should the CA reflect off-balance-sheet exposures?*
34. *Under what circumstances should U.S. GAAP be used or adjusted to determine the exposure amounts of insurance liabilities under the CA?*
35. *What considerations should the Board apply in determining the various factors to be applied to the amounts in the risk segments in the CA?*
36. *What challenges are there in determining risk factors for global risks?*
37. *What criteria should the Board consider in developing the minimum capital ratio under the CA and a definition of a "well capitalized" or "adequately capitalized" insurance institution?*